Caron's Corner Transcript – 8.21.2023

From Jackson Hole to the Rabbit Hole: Is a Recession in the Cards?

- Up until now the Fed has focused on growth, and only worried about inflation.
- But that was then and things may have flipped, where today they focus on inflation and only worry about growth.
- The central bankers at Jackson Hole seem to be heading down Alice's proverbial "rabbit hole" and doing less to discourage a recession. But, this may be the card they are playing.
- The mandated inflation target could be viewed as Wonderland's Queen of Hearts, with the central bankers her playing cards and loyal defenders.
- Talking tough on inflation and keeping rates high until the job is done will be part of their story. But reading between the lines is the veiled threat of a mild recession.
- In the end, what might a mild recession look like and what investment opportunities might it bring? We discuss.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. From Jackson Hole to the Rabbit Hole: Is a Recession in the Cards? The Fed had a choice: it focused on growth but worried about inflation. But that was then. Now this may have flipped. They may now focus on inflation and worry about growth, and it may seem odd for central bankers at Jackson Hole to take a trip down the rabbit hole and do less to discourage recession. But this may be the very veiled angle that they are playing. Let me explain.

The sooner we have a recession, the more mild and shorter it will likely be. The longer it takes for a recession to occur, the deeper and more protracted it may likely be. A mild recession also has the potential benefit to lower inflation to target levels with minimal economic costs. Remember that economists always think in terms of marginal utility benefits and costs. In addition, a near term recession will alleviate the need for the Fed and other central banks to keep hiking interest rates and risk that something major breaks. So talking tough on inflation and keeping rates high until the job is done will be part of the script. But reading between the lines is the veiled threat of a mild recession.

Does this sound strange? Well, I'm sticking with the Alice in Wonderland theme, the source of the "rabbit hole" reference in the title. Think of the mandated inflation target as the proverbial Queen of Hearts and the central bankers as the playing cards who are her loyal defenders. Maybe the way to get to target is via this strange journey. So what might a mild recession look like, and what investment opportunities might it bring? Let's get into it.

So let's take that journey into the rabbit hole of central bank policy. Forecasting is difficult, they say ironically, especially when it's about the future. Let me instead provide an educated guess about what a mild recession may look like and why central bank policy may be steering us toward one. We will start with the bond market and economic fundamentals. Many forecasters are calling for rate cuts sometime

in the first half of 2024. This will likely happen only if indeed we see a recession, and in the mild recession scenario, we could see the Fed move policy rates toward 4% which is 150 basis points lower than where they are today. Credit default risks may rise but will be containable within reason given the already higher all-in yields of credit in both investment grade and high yield. Spreads may widen but likely remain atypically contained, especially given the already low dollar price of many bonds that are trading below par. The yield curve would likely steepen with front-end yields moving lower while outperforming longer dated bonds. This implies that even at current yield levels, longer duration fixed income may not be a “sure thing” hedge against a mild recession. Short duration assets may offer more value and be a better hedge. Our duration and yield curve thinking is based on the view that inflation will likely remain above 2% target levels on average even during a mild recession. We still think labor markets remain tight historically, but it's possible to see the unemployment rate rising toward rising to 4.5%. Consumption will slow but not collapse and this will support GDP growth.

Moving on to equities, the story here is more complicated and has many more scenarios. To start, even a mild recession is a headwind for equity valuations. Slower growth strains wages and as labor softens, reduced confidence leads to reduced consumption, narrows profit margins, slows earnings growth rates and ultimately leads us all to wonder what multiple is right for these conditions. I suppose probably lower multiples, but the question is whether that's already in the price? After all, first quarter and second earnings growth rates were negative and third quarter is under pressure as well. If the market expects a mild recession, it may look through this and keep multiples and prices high despite slower earnings. To be sure, if we get a hard landing, then earnings will come under greater pressure and adjust lower, taking multiples and market levels with it. So which scenario is correct? Well, we can't be sure but we still need to pick one. I'm in the soft landing camp and as a result, I see the recent equity sell-off as a healthy and needed correction. We are being patient, but still see a buying opportunity.

From the Jackson Hole symposium the message is that central banks will remain vigilant in fighting inflation with a goal of bringing it back to target. Keep in mind this is pure boilerplate language and they're bound by mandate to say this. The message will also include that they do not require a recession to achieve that goal again. Remember, no central bank has a mandate to create a recession. So this really isn't new news. But the dilemma that needs sorting out is that it's unlikely that both can be true - the immaculate disinflation scenario - a scenario where inflation falls and we don't have a recession. It’s hard to believe that's actually going to be the case because we really haven't seen that historically, but that's exactly what's being posed by many of the central bankers. For central banks to remain credible on fighting inflation, they're still going to have the threat of higher rates. That will remain on the table and will weigh on growth, perhaps just enough to lower inflation. Aiming for a mild recession may do the trick and may be the veiled message coming from Jackson Hole. In the end, this may be where the white rabbit is leading us.

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